REDEVELOPMENT – TAX ASPECTS

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Special Story

1. Background

1.1 With increase in population and people migrating from rural areas, demand for urban housing is increasing and urban area is running out of land. It is estimated that there are more than 52,000 slums in India, with more than 8 million dwelling units. Out these 17,000 slums with more than 3 million dwelling units are situated in Maharashtra.

1.2 In view the fact that land cannot be created; supply of land for new construction would be from:

a) Redevelopment of old buildings,

b) Development of slums.

c) 'Supply from old mills and salt pans' – in cities like Mumbai

However environmental disquiet has held the plans for developing salt pans. Hence currently redevelopment of chawls, dilapidated buildings, some crumbling co-operative societies and slums would drive the market.

1.3 Redevelopment of old structures involves various complicated and peculiar regulatory and tax issues. Important parties to the redevelopment scheme are:

i) Land owners/society;

ii) Tenants/flat owners/dwellers/society members;

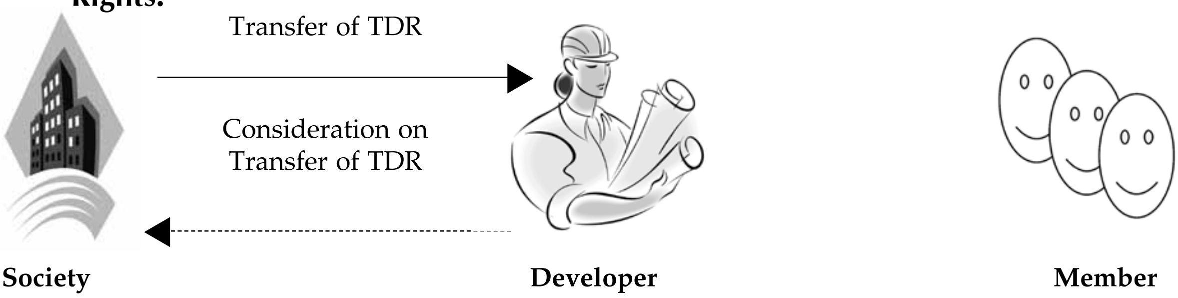
iii) Developers

iv) Various Governmental agencies.

However for the purpose of taxation we are concerned with tax issues that may surround first three parties only. Tax implication on developers are specifically not dealt herewith since all the expenses incurred by the developer would be in the ordinary course of business and no specific tax issue arises merely on undertaking redevelopment. Though there are various industry specific issues which arises on all types of construction. During the course of re-development of society, society and/or members are in receipt of sum in one or the other form.

Let us consider each of these situations one by one.

2. Receipt of consideration by Society on transfer of Transferable Development Rights:



2.1 Before considering tax impact on transfer of 'Transferable Development Rights' (TDR) let us understand 'what is TDR?' TDR is not defined under the Income-tax Act. As per FEMA (Permissible Capital Account Transactions) Regulations, 2000 - Regulation 2(d) – TDR means certificates issued in respect to category of lands acquired for public purpose either by Central or State Government in consideration of surrender of land by the owner without monetary compensation, which are transferable in part or whole. Every city/town has its own development plans. In Maharashtra, city/ town development plans are prepared under Maharashtra Regional and Town Planning Act. City/town plans reserves some area for the various general public utility purposes like recreational ground, school, road, hospitals etc. Reserved plots are required to be surrendered to the local authorities for their reserved use. However on such surrender, owners are to be compensated adequately. Providing monetary compensation to the owners would put gigantic pressure on State / Local Government's financial resources. Hence new concept of TDR has been evolved under Development Control (DC) Regulations. DC regulations are district or town specific. Under DC regulations, development potential of reserved land is isolated from land. This isolated right is called as TDR, which can be used to load additional floor space (in addition to permitted area) on other properties. Local authority generally issues a certificate for TDR which is known as Development Rights Certificates (DRC). Holder of DRC can transfer them for the monetary consideration. TDR may also arise due to additional Floor Space Index (FSI). In Mumbai TDR arises under Development Control Rules, 1991 of the Bombay Municipal Corporation. Such TDR can be utilized on any plot, vacant or already developed or by erection of additional storeys subject to the availability of FSI and conditions prescribed under DC Regulation.

2.2 With this background let us examine whether receipt of sum on transfer of TDR is taxable in the hands of society?

2.3 Under section 2(14) of IT Act, capital asset means property of any kind (other than specifically excluded) held by assessee. 'Property' is a term of the widest import and, subject to any limitation which the context may require, it signifies every possible interest which a person can clearly hold or enjoy.[1] The word 'property' not only includes tangible assets but also intangible assets. In view of this TDR is a capital asset.

2.4 Section 48 sets out the mode of computation of income under the head Capital gains by providing that the expenditure incurred wholly and exclusively in connection with the transfer of a capital asset along with the cost of acquisition and cost of any improvement, if any, shall be deducted from the full value of consideration received or accrued as a result of the transfer of capital asset. The Hon'ble Supreme Court in the celebrated case, B.C. Srinivasa Setty[2] has held that transfer of capital asset which does not have any cost of acquisition does not result into capital gains chargeable to tax under section 45. The law is settled and there is no dispute on the said position that when an asset has no cost of acquisition, the gains on sale or transfer of same cannot be brought to tax.

2.5 The right to receive TDR arises in the hands of society because society is the owner of the land and building. Until the point of time DC regulation came into existence, the assessee did not have right to receive and apply for the TDR. In case where TDR is transferred, the society is the owner of the land and building and continued to remain the same, even after transfer of the said capital asset. In other words what society transfer is not the plot or the building, but parts with the new right which did not result in parting with land or building. Further the

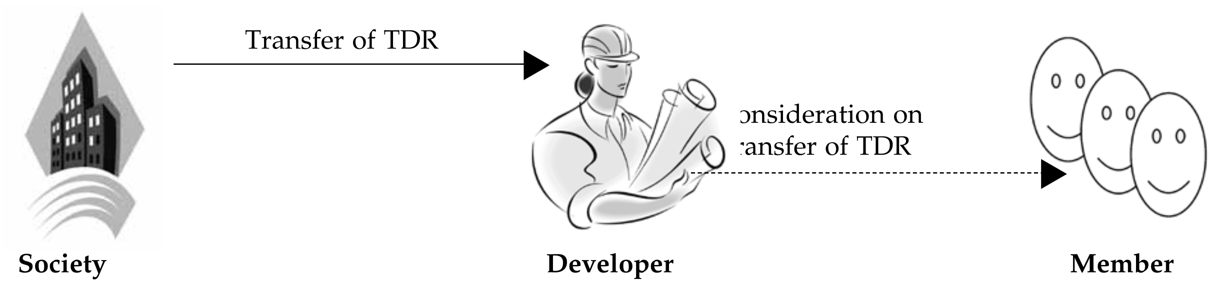
1 *Ahmed G.H. Ariff vs. CWT[1970] 76 ITR 471 (SC)*
2 *CIT vs. B.C. Srinivasa Setty [1981] 128 ITR 294 (SC); [1981] 5 Taxman 1 (SC)*

rights are acquired by virtue of being owner of the plot in the specified area but that does not mean that the cost incurred on the plot is the cost of acquiring these rights. Thus, the cost of the land and building of the existing structure could not be attributed to the additional FSI received by means of DC regulation. The costs of obtaining local authority approval for the building plan can also not be said to be the costs of acquisition of these rights as these rights do not arise by the virtue of getting these approvals but by the virtue of a legal right independent thereof.[3]

2.6 As discussed earlier such right is a capital asset but in order to compute capital gains apart from the existence of capital asset, there should be sale consideration accruing as a result of transfer of capital asset as well as the cost of acquisition of the asset along with the cost of any improvement thereto, if any. The legislature in its wisdom brought out certain categories of capital assets under section 55(2) as having cost of acquisition at ₹ nil, where such assets have not been purchased by the assessee for consideration. The effect of this sub-section is that when the assets so specified in sub-section (2) of section 55 are transferred, then the cost of acquisition has been taken at ₹ nil except where the assessee had acquired such assets by means of purchasing from the previous owner and the computation of the capital gains would be done accordingly. There is a difference in the situation when cost of acquisition is ₹ nil and where the cost of acquisition cannot be ascertained or no cost of acquisition has been incurred.

2.7 The items of capital assets specified in section 55(2) are those for which the cost of acquisition shall be taken at ₹ nil for computing capital gains. However if the assessee had not incurred any cost of acquisition on a capital asset and such capital asset does not fall in the category of the capital assets specified in section 55(2) then the judgment of the Hon'ble Supreme Court in B.C. Srinivasa Setty shall apply and no capital gains would be charged. In view of this, no capital gains can be charged on the transfer of the additional FSI by the society.[4]

3. Consideration for transfer of TDR received by members:



3.1 Another situation may arise where on transfer of TDR amount is received by society members and not by the society and developer also agrees to carry repairs to the building. Under these scenario what would be the tax implications?

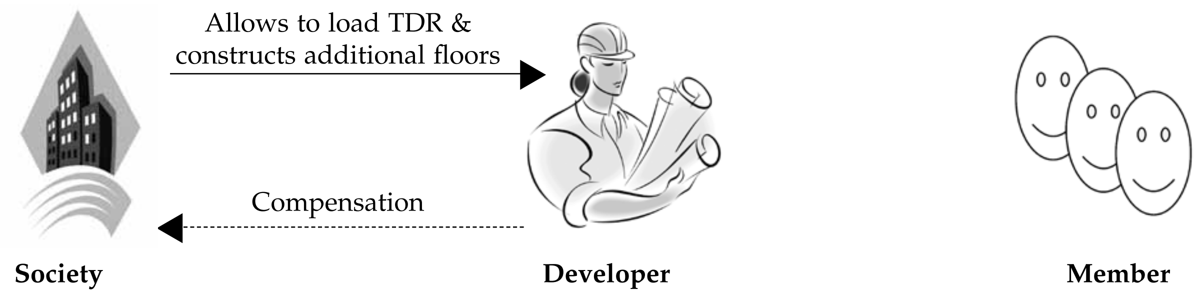
3.2 Similar issue has arisen in the case of Lotia Court Co-op. Housing Society Ltd.[5] wherein the assessee is a registered society consisting of 11 members. The assessee society was entitled to receive

3 *Jethalal D. Mehta vs. DCIT [2005] 2 SOT 422 (Mum.)*
4 *New Shailaja Co-operative Housing Society Ltd. vs. ITO [2010] 36 SOT 19 (Mum.)*
5 *ITO vs. Lotia Court Co-op. Housing Society Ltd. [2009] 27 SOT 36 (Mum.)*

certain TDR from the Municipal Corporation of Mumbai, as per which additional floors could be constructed on the existing building. The said right to receive TDR was assigned to a builder by the members of the society for the purpose of repairing the said building. The assessee entered into an agreement with the developer wherein the terms of settlement vis-à-vis the members of the society were agreed upon. Separate agreement was entered into by the respective owners of the flats, i.e., the members of the society with the developer for the assignment of the TDR and construction of additional floors in respect of each flat owned by the respective parties. The benefit of the additional TDR was derived and enjoyed by the members of the assessee society and no consideration whatsoever was received by the assessee society for the assignment of the TDRs and for carrying out the repairs of the building and construction of the additional floors. The Assessing Officer treated the consideration received/receivable by the members of the society as income in the hands of the society.

3.3 The Tribunal observed that the assessee society was not the owner of the land. The flats were owned by individual members who had formed the society but the plot of land was not transferred to the society. Certain repairs and redevelopment of the flat had to be undertaken and an agreement was written between the assessee society and the developer for the repairs of the building and for construction of additional floors in the flats of individual flats owned by the members of the society. An agreement was entered into between the assessee society and the developer but no consideration for the transfer of TDRs owned by the flat owners individually was received by the assessee society nor any area in the constructed portion was allocated to the assessee society. The members of the society individually entered into an agreement with the developer for the construction of additional floors or portions annexed to their individual flats and for the repairs of the building. The assignment of the TDR to the developer and in turn the additional floors to be constructed and also repairs/renovation of the building to be carried out, does not entail accruing of any income in the hands of the assessee society, who is not the owner of the plot. Even in the case of flat owners who owned the individual flats in the respective names, following the decisions of Jethalal D. Metha's case it has been held that there is no question of taxability of receipt on account of sale of additional FSI received by the assessee by virtue of transfer of TDR.

4. Sum received by society for allowing developer to construct additional floors on the existing structure

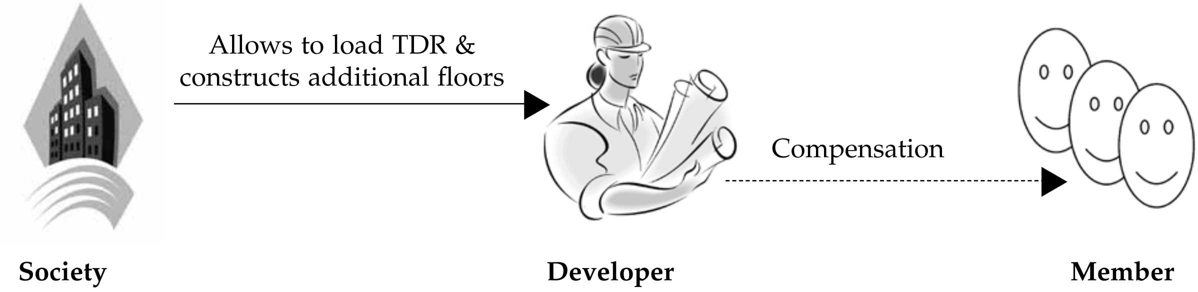


4.1 Under this scenario, existing co-operative housing society owns a building. This building had been constructed after utilising the entire FSI available to it at that point of time. Therefore, no right was available for any further construction on this plot of land. However, the Municipal Corporation relaxed the development regulations. Due to relaxation additional loading of TDR, is allowed. As per the scheme, either the society could construct additional floors by purchasing TDR from the market or could transfer such right to any other builder or developer who had the TDR or who could arrange the TDR from the market. In short, the society is entitled to construct additional space. In view of the availability of such right, the society entered into an agreement with developers for construction of additional floors on the existing structure of the society's building and society receives compensation from developer for allowing development.

4.2 The society acquired the right to construct the additional floors by virtue of DC Regulation which could not be available to society on expenditure of money. Prior to DC Regulation, no society had any right to construct the additional floors. Hence it was not a tradable commodity. Such right exclusively belonged to the building owned by the society. It could not be transferred to any other building. Similarly, similar right belonging to other societies could not be purchased by society for the purpose of constructing additional floors in its own building. Therefore, such right had no inherent quality being available on expenditure of money and therefore, the cost of such asset could not be envisaged. Therefore, the right (to construct additional floor) acquired by the society did not fall within the ambit of section 45 itself. The amended provisions of section 55(2) were also not applicable, since such right was not covered by any of the assets specified in section 55(2)(a).

4.3 Such right being no cost asset as discussed above, applying decision in case of B.C. Srinivasa Setty, taxing mechanism fails and amount received by the assessee society is not chargeable to tax under section 45.[6]

5. Sum received by society members for allowing developer to construct additional floors on the existing structure



5.1 The individual is a member of a housing society which owned certain property viz. land, buildings and flats. A developer is in possession of TDR is looking for properties wherein it could utilize TDR. The society enters into an agreement with the property developer to grant permission to construct additional floors in the existing building. The members of society received certain sum on account of grant of development rights to developer. Whether such sums received by the member of the society would be chargeable to tax?

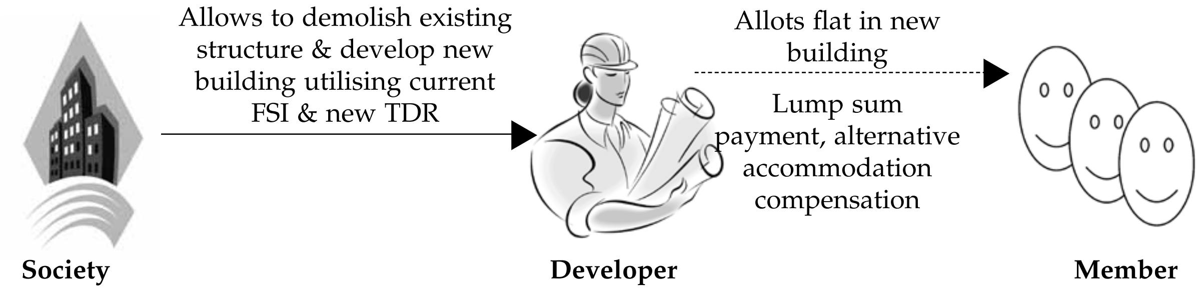
5.2 The definition of capital asset given in section 2(14) is for the purpose of the entire Act and not for the purpose of capital gains only. Although a particular thing, right or interest may be a capital asset within the meaning of section 2(14), yet transaction in relation thereto may not give rise to taxable capital gains. This would be because of the fact that no transfer as envisaged by the Act is involved. Similarly, there would be certain capital asset which could not give rise to capital gain because of the fact that no cost of acquisition can be envisaged in the acquisition of that asset.

6 *Maheshwar Prakash-2 Co-op. Hsg. Society Ltd. vs. ITO[2008] 24 SOT 366 (MUM.); Om Shanti Co-op Hsg. Society Ltd. vs. ITO ITA No. 2550/Mum./2008*

5.3 Neither the society nor the members owned or possessed any TDR. The TDR is owned and possessed by the builder and in terms of the regulations framed by Municipal Corporation, it was permissible for the building to utilize the said transferable development rights in or with respect to the prescribed area including the land and building owned by the society. The members of the society had paid for the purchase of the flat, which confers very limited rights in terms of the regulations of the society and 'right to grant permission for additional construction', as such does not form part of any rights; but it arises on account of the volition or voluntary desire of a person. Such permission cannot be obtained by enforcing any rights or obligation arising from the agreement to purchase the flat and/or the regulations of the society. Further the act of affirmative voting in favour of the resolution passed in the EOGM is not a recurring event to likely happen regularly, nor it is expected to happen again and again and, hence, the receipt of money for affirmative voting for the resolution is not a receipt in the nature of an income.[7]

5.4 Accordingly, the voluntary consent given cannot constitute or form part of the bundle of rights which are owned or possessed by the member in or with respect to the tenure of the flat granted to the member by the society. The area occupied by the members was only a "measure" in quantitative terms inasmuch as the extent of hardship which may be faced cannot be quantified. When an additional construction is made, the location of the flat, as such, is of no significance or importance, since everyone suffers the hardship and the extent cannot be determined through any "measure". The members had not transferred any rights in or with respect to the flat or compromised any rights in or with respect to the flat or suffered any deficiency or limitation in or with respect to the rights in the flat in fact they had added the risk of adding load to the building. Accordingly, the cost of flat cannot be any measure for the purpose of finding out the cost of the alleged "capital asset" and the alleged "transfer" of such asset. The assessee is neither holding any capital asset nor the same has been sold, exchanged or relinquished. In other words there is no transfer of capital asset.[8]

6. Existing building is demolished and flat owners are granted new flat in exchange of old flats:



6.1 The individual is a member of a housing society which owned certain property viz., land, buildings and flats. A developer having possession of TDR was looking for properties wherein it could utilize TDR. The society entered into an agreement with the developer and transferred the entire development potential. The developer demolishes existing structure and utilises original FSI and also loads additional TDR so that he could construct area in addition to the area of current building. He provides flats to the members of same area or flats with larger area. A member also

7 *CIT vs. David Lopes Menezes [2010] 195 Taxman 131 (Mum.)*
8 *Deepak S. Shah vs. ITO [2009] 29 SOT 26 (Mum.)*

receives certain lump sum amount and during the construction period each member is provided with a fixed sum towards compensation for alternative accommodation. Whether such sums received by the member of the society would be chargeable to tax?

6.2 Circular No. F.N. 4 / 28 / 68 – WT DT. 10-1-1969 and 27-1-1969 explaining the provisions of section 5(1)(iv) of Wealth-tax Act, the Board clarifies that flats vest with individual members of society and wealth tax exemption will be available to individual members. Similarly this concept has also been recognized under Bombay Stamp Act as on the conveyance in favour of the housing societies, stamp duty paid by the purchasers of flats on ownership agreements is deducted from the stamp duty payable on the market value of the property transferred in favour of the society. In short, members of the society are the legal owner of the flat in the society.

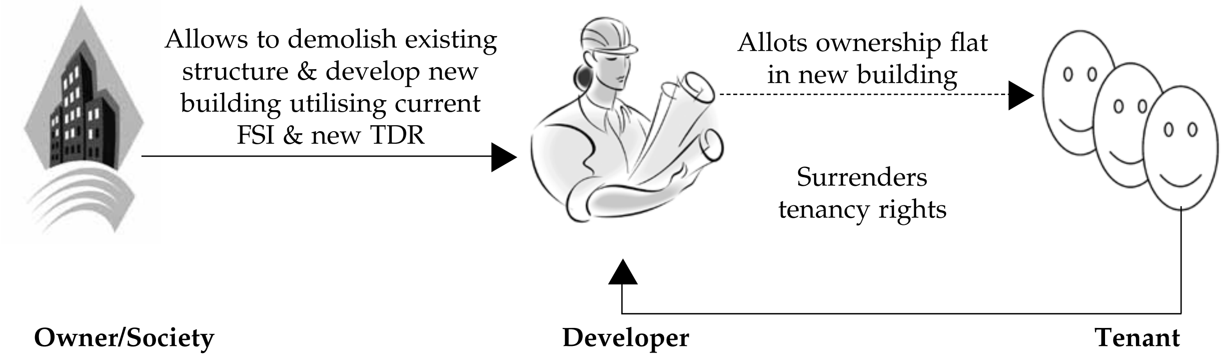
6.3 In case where the existing members exchange old flats with the new flats of the same size or larger size, there is a transfer in terms of S. 2(47) of the Act and this gives a rise to the taxable event. However such member is also entitled to claim exemption u/s 54 where he is allotted residential flat in exchange of the existing flat. But exemption u/s 54 is available only for a residential premise is allotted against existing residential flat. Where commercial premises e.g. shop, office is allotted against the existing residential or commercial premises no exemption is available u/s 54. In case a residential premise is offered against commercial premises deduction would be available u/s 54F. But exemption u/s 54EC would be available in case where new premises is not an residential premises (by investing capital gains in the specified bonds). These exemptions are subject to fulfilment of the various conditions prescribed therein. However computation of capital gains and exemption would be a tricky exercise. Gross amount of consideration would the cost incurred by the developer on reconstruction of existing area (including additional area allotted to the owners), the cost of acquisition of TDR space will be the consideration and gain is to be computed by deducting from it the indexed cost of acquisition of the capital asset. Gains would be long term or short term depending upon the holding period of old premises. In case holding period of the asset is less than 36 months, assessee would not be entitled for the indexed cost of acquisition and also exemptions u/s 54 & 54F. Period of holding of the new premises would not include the period of old premises. In case new premises is transferred within 36 months, assessee would lose exemption u/s 54 / 54F, if claimed earlier and gains on sale of new premises would be chargeable as short term capital gains.

6.4 Receipts of lump sum amount by the members of the society may be taxable in their hands. However in case it could be demonstrated that such sums is received towards the transfer of TDR as discussed in the earlier paras it may be possible for the assessee to claim such amount exempt from tax. In case members are able to demonstrate that such sums are received as compensation for injuriously affecting their existing rights, amount may not be exigible to tax in view of decision of Lohtse Co-op. Housing Society Ltd.[9]

6.5 Receipt of compensation towards alternative accommodation may be taxable as income from other sources. Further the amount paid towards actual rent may be claimed as deduction. As per another school of thought, such amount is not taxable since these sums are nothing but compensation for dislocation and hardship that may cause to owners.

9 *Lohtse Co-op. Housing Society Ltd. vs. Seventh Income-tax Officer [1994] 51 ITD 608 (Bom.)*

7. Existing building is demolished and tenants allotted new premises on ownership basis.



7.1 This situation is similar to that what is discussed in para 6, but with the difference that premise occupants are tenant and not the owners. Under the redevelopment scheme tenants surrender their tenancy rights and in lieu of this they are allotted new premises on ownership basis.

7.2 The tenancy right is a capital asset with nil cost of acquisition, unless any amount paid to acquire it. The surrender of the tenancy right is a 'transfer' u/s 2(47) and and would give rise to taxable event. The consideration received, therefore, is a capital receipt within the meaning of section 45.[10] Period of holding of tenancy rights would determine whether gains are long-term or short-term. In case gains are long-term tenant can claim exemption u/s 54F/54EC as the case may be. Where a tenant is allotted new residential premises he could claim exemption u/s 54F. However where premises allotted is not a residential premises he may claim deduction u/s 54EC by investing capital gains in the specified bonds. For the purpose of determining the period of holding of new premises allotted, period of holding of tenancy is not considered.[11]

7.3 Another tricky issue arises, what would be the date of surrender of tenancy rights. Generally surrender agreement provides that tenant would be continuing to hold tenancy till the date of allotment of new premises and continue to pay monthly rent to the owners. Under this situation whether giving possession of the tenanted premises to the owners/developer would be considered as the date of transfer or contractual agreed date would be considered as date of transfer. There are two schools of thought in this regard. However better view is that for the purpose of income-tax tenancy would be treated as surrendered on the date on which possession of premises is granted to the developer.[12] However merely entering into agreement without parting of possession to the developer would not create taxable event.[13]

8. Other points

8.1 **Piecemeal transfer:** It may so happen that merely upon executing the agreement it does not create any right, title or interest in the whole property. Upon receipt of the part consideration proportionate possession is granted to the developers during the relevant point of time. Here issue may arise whether whole of the consideration received or receivable would be charged to tax or consideration linked with the grant of proportionate possession in property

10 *CIT vs. D.P. Sandu Bros. Chembur (P.) Ltd. [2005] 142 Taxman 713 (SC)*
11 *CIT vs. D A Irani (1999) 151 CTR 288 (Mum.)*
12 *ACIT vs. G.D. Thirani [1999] 70 ITD 148 (Cal.)*
13 *Megji Mathradas vs. JCIT [2000] 75 ITD 52 (Mum.)*

would be considered for computing capital gains? In such a scenario capital gains shall be arising only on the said proportion amount of consideration received and possession granted. Hence proportionate consideration is charged to tax in the relevant year and not on the entire consideration stipulated in the sale agreement, is chargeable to tax.[14]

8.2 In case amount is not chargeable as capital gains whether the same would be taxable as income from other sources?

Section 14 of the Act provided that "All income shall for the purposes of charge of income-tax and computation of total income be classified under six heads of income," namely:

(A) Salaries;

(B) Interest on securities;

(C) Income from house property;

(D) Profits and gains of business or profession;

(E) Capital gains;

(F) Income from other sources unless otherwise, provided in the Act.

S. 56 provides for the chargeability of income of every kind which has not to be excluded from the total income under the Act, only if it is not chargeable to income-tax under any of the heads specified in section 14 items A to E. Therefore, if the income is included under any one of the heads, it cannot be brought to tax under the residuary provisions of S. 56.

From the discussion in the preceding paras there is no dispute that various sums received is on account of transfer of capital asset. If the income cannot be charged under section 45, because of the inapplicability of the computation provided under section 48, it cannot be taxed at all. Furthermore, it would be illogical and against the language of section 56 to hold that everything that is exempted (including failure of computing mechanism) from capital gains by statute could be taxed u/s 56.[15] S. 56 applies in case money is received without consideration. In the instant case society or member has one or the other right. Hence it could be argued that amount received is not without consideration.

Conclusion

Albert Einstein said that "The hardest thing in the world to understand is income tax". It is essential for the property owners to ensure a smooth transition during redevelopment process, transaction is appropriately structured considering the legal and tax implications, so that undesirable tax consequences are kept at bay.

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14 *Ajai Kumar Sah Jagati vs. ITO (1995) 55 ITD 348 (Del.); G. G. Dandekar Machines Works Ltd. vs. JCIT, ITA No. 181/Mum/2001, Bench – F*

15 *CIT vs. D.P. Sandu Bros. Chembur (P.) Ltd. [2005] 142 Taxman 713 (SC)*

> Civilization, in the real sense of the term, consists not in the multiplication, but in the deliberate and voluntary reduction of wants. This alone promotes real happiess and contentment, and increases the capacity of service.
>
> — *Gandhi*